No. 87-562

In the Supreme Court of the United States

OCTOBER TERM, 1987

SECURITIES INDUSTRY ASSOCIATION, PETITIONER

v.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

MEMORANDUM FOR THE FEDERAL RESPONDENT IN OPPOSITION

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TABLE OF AUTHORITIES

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Petitioner contends that the affiliation of a bank holding company with a firm that offers both brokerage services and investment advice is barred by Section 20 of the Banking Act of 1933 (Glass-Steagall Act), 12 U.S.C. 377, which prohibits any bank that is a member of the Federal Reserve system from affiliating with any entity "engaged principally in the issue, flotation, underwriting, public sale or distribution" of securities.

1. In August 1985, the National Westminster Bank PLC and its subsidiary NatWest Holdings, Inc. (collectively NatWest) submitted an application to the Federal Reserve Board (Board) for permission to provide investment advice and securities brokerage services to institutional customers through a newly formed subsidiary, County Securities Corporation (CSC) (see Pet. App. 3a-5a, 21a-23a). Under the terms of the application, CSC would execute trades only at the request, and for the account, of customers; it would not act as a principal or

underwriter, and would not bear any financial risk with respect to the securities that it recommended or brokered. CSC would receive all of its compensation in the form of fees for the execution of customer trades. *Id.* at 4a.

After taking comments from the public, including petitioner, the Board approved the application (Pet. App. 21a-52a). With respect to the issue raised by the petitioner, the Board determined that CSC's provision of both brokerage services and investment advice would not cause NatWest to violate Section 20 of the Glass-Steagall Act. Relying on this Court's decision in *Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 207 (1984) (*Schwab*), the Board explained that CSC's proposed activities would not constitute the "public sale" of securities within the meaning of Section 20 because CSC would act solely as an agent for its customers. CSC would not use its own funds to buy and sell securities, would not make a market in securities with its own funds, and would not offer securities to the public as an agent of the issuer; therefore, the Board concluded, "CSC's full-service brokerage services would not involve any of the factors used by the Supreme Court [in *Schwab*] in describing the term public sale in section 20." Pet. App. 42a. The Board also found this conclusion consistent both with the Glass-Steagall Act's legislative history (see *id.* at 43a) and with the Board's long-standing position on the Glass-Steagall implications of full-service brokerage (see *id.* at 44a-48a).

The Board also rejected the argument that CSC's proposed activities might pose the "subtle hazards" that are the targets of the Glass-Steagall Act. The Board noted that this Court "has not relied on the possibility of 'subtle hazards' as determinative of the legality of a particular activity, where the activity is permissible under the literal terms of the statute" (Pet. App. 49a). The Board also explained that "virtually all of the potential hazards cited by [petitioner] as resulting from the proposal * * * are equally as likely to occur when a banking organization provides

investment advice alone" (*ibid.*)—and, the Board noted, this Court has found that banks do not violate the Glass-Steagall Act when their affiliates provide such advice (see *id.* at 50a; *Board of Governors* v. *Investment Co. Institute,* 450 U.S. 46 (1981) (*ICI II*)). Finally, the Board noted that, in any event, none of the potential hazards cited by petitioner is significant here (see Pet. App. 50a-51a).

The Court of Appeals for the District of Columbia Circuit affirmed the Board's decision (Pet. App. 1a-20a) as "a reasonable interpretation of the language and legislative history of the Act [that] is consistent with prior precedent" (*id.* at 3a). The court noted *Schwab's* holding that a bank affiliate may offer discount brokerage services (that is, brokerage services without accompanying investment advice) (*id.* at 7a-8a) and *ICI II's* holding that bank affiliates may offer investment advice and manage customer portfolios (*id.* at 8a). Therefore, the court explained, "the only issue presented here is whether the combined provision of investment advice and securities brokerage services transforms these separately permissible activities into a 'public sale' within the meaning of section 20" (*ibid.*). Like the Board, the court answered this question in the negative, finding that "[t]he addition of investment advice to brokerage activities does not implicate any of the activities which the *Schwab* Court described as traditionally associated with underwriting" (*id.* at 9a).

The court also rejected petitioner's argument that CSC's activities would pose "subtle hazards." Looking to *Schwab*, the court explained that subtle hazards arise only when bank affiliates hold particular securities for sale, or purchase and sell securities for their own accounts—activities in which CSC will not be engaged (Pet. App. 14a). And the court added that "[m]ost of the alleged hazards raised by [SIA] have been addressed by the Supreme Court and rejected as not within the category of activity Con-

gress sought to prohibit under the Act in the absence of an interest in a particular security" (*id.* at 15a).

2. The considered decisions of the Board and of the court of appeals are plainly correct; they do not conflict with any holding of this Court or of any other court of appeals. Further review is accordingly unwarranted.

a. In *Schwab*, this Court held that bank affiliates may lawfully provide discount brokerage services, explaining that the term "public sale" is used in Section 20 of the Glass-Steagall Act to prohibit "the *underwriting activity* described by the terms that surround it [in the statute]" (468 U.S. at 218 (emphasis added)); the Court added that Section 20 was enacted because of "[c]ongressional concern over the *underwriting* activities of bank affiliates" (468 U.S. at 220 (emphasis added)). In *ICI II*, the Court held that the provision of investment advice and "[t]he management of a customer's investment portfolio—even when the manager has the power to sell securities owned by the customer"—does not run afoul of the Glass-Steagall Act (450 U.S. at 63); the Court noted that the Act was directed against "securities firms affiliated with banks [that] had engaged in perilous underwriting operations, stock speculation, and maintaining a market for the bank's own stock" (*id.* at 61-62).[1] Since the Court has thus held that bank affiliates may provide brokerage services and may provide investment advice, the only question in this case is whether one affiliate may provide both of those services.

The reasoning of this Court's decisions, especially their emphasis on underwriting and investment banking, makes it quite clear that a single bank affiliate may offer both services. As the court below explained, "[t]he addition of investment advice to brokerage [services] activities does

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[1] The Court's statements in *ICI II* involved Section 21 of the Glass-Steagall Act, 12 U.S.C. 378, a provision that is ~~less~~ more stringent than Section 20. See 450 U.S. at 61 n.26; see also Pet. App. 8a n.6.

not implicate any of the activities which the *Schwab* Court described as traditionally associated with underwriting" (Pet. App. 9a): CSC will not purchase securities for its own account, make a market in securities, act as a principal or underwriter, or bear any financial risk with respect to any security that it either brokers or recommends. Because CSC will not engage in underwriting activities, its proposed operations are entirely consistent with the plain terms of the Glass-Steagall Act.[2]

In challenging this conclusion, petitioner suggests (Pet. 11) only that CSC will somehow acquire a " 'salesman's interest' " in the securities that it recommends when it provides investment advice. The court of appeals correctly noted, however, that "CSC will receive a commission only on transactions it executes, regardless of whether CSC advised the customer to purchase the security or whether the customer followed that advice" (Pet. App. 14a); "[t]hus, CSC's financial incentive relates solely to the *number* of shares it trades and not to any particular security" (*id.* at 15a (emphasis in original)). As in *Schwab*, the bank affiliate here accordingly "trades only as agent," and its "profits depend solely on the volume of shares it trades and not on the purchase or sale of particular securities"

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[2] Petitioner seriously errs in asserting that the court of appeals "conceded" that the activities at issue here "fall within the literal meaning of the term 'public sale' in Section 20" (Pet. 10). In fact, the court explained that *petitioner* "ha[d] not raised a serious challenge to the Board's finding that CSC's proposed activities do not fall within the literal meaning of 'public sale' as interpreted by the Court in *Schwab*" (Pet. App. 11a); the court of appeals rejected petitioner's attempt to substitute a dictionary definition of the statutory term for the one provided by this Court (see *ibid.*). Equally unfounded is petitioner's assertion (Pet. 10) that the court of appeals "restrict[ed] the reach of 'public sale' solely to activities on behalf of issuers"; the court made it quite clear that the Glass-Steagall Act is implicated when a bank affiliate purchases securities for its own account in the secondary market or has an interest in the purchase or sale of a particular security (see, *e.g.*, Pet. App. 14a).

(468 U.S. at 220). And as the Court there concluded, these activities are hardly equivalent to the underwriting activity that concerned the drafters of the Glass-Steagall Act.

b. Citing *Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 137 (1984) (*Bankers Trust*), petitioner also contends (Pet. 12-14) that the decision below will pose "subtle hazards" that, while not specifically addressed in the Glass-Steagall Act, were nevertheless intended to be prevented by the statute. As the Court has repeatedly explained, however, the subtle hazards that create concerns under the Act are those that are "associated with underwriting" (*Schwab*, 468 U.S. at 220). See *Bankers Trust*, 468 U.S. at 145 (quoting *Investment Co. Institute* v. *Camp*, 401 U.S. 617, 630 (1971)) (warning against " 'the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business' "). Because CSC will not engage in investment banking, there is no need to search for subtle hazards in this case. In any event, both the Board (see Pet. App. 50a-51a) and the court of appeals (see *id.* at 14a-17a) found on the record here that CSC's proposed activities would not create any special risks, and petitioner has offered no reason to doubt this factual conclusion.[3]

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[3] As both the Board (see Pet. App. 49a-50a) and the court of appeals (see *id.* at 15a-16a) explained, the purported hazards identified by petitioner in the proceedings below—the danger that NatWest might make unsound loans to the issuers of securities recommended by CSC, that CSC might recommend securities issued by NatWest customers, and that NatWest might lose its reputation for prudence if a depositor who follows CSC's advice does poorly—are present whenever a bank offers investment advice. In *ICI II*, however, the Court found these hazards illusory in holding that a bank affiliate *may* offer investment advice (at least where the investment advice is suitably regulated by the Board). See 450 U.S. at 66-67. The same answer disposes of the single "hazard" that petitioner offers this Court (see Pet. 13-14): the possibility that CSC might promote and sell se-

Similarly without merit is petitioner's assertion (Pet. 14-15) that the Board adopted a "regulatory approach" to the implementation of the Glass-Steagall Act, of the sort that the Court rejected in *Bankers Trust*. It is true, of course, that the Board may not permit by regulation activities that Congress has prohibited in the Act. See *Bankers Trust*, 468 U.S. at 147-148. But the Board plainly did no such thing in this case. Rather, it concluded that CSC's proposed activities are *not* foreclosed by the plain terms of the Glass-Steagall Act; it then imposed additional restrictions on CSC to guarantee the safety of its operations. See Pet. App. 51a; *id.* at 17a-18a. This sort of regulatory activity is clearly appropriate and was approved by this Court in *ICI II*. See 450 U.S. at 62, 66-67 & n.39.

c. Finally, petitioner contends (Pet. 7-8 & n.14) that the Board's decision in this case represents a departure from prior administrative practice. As the Board explained in some detail, however, its ruling here is consistent both with longstanding bank practice and with the Board's own earliest interpretations of the Glass-Steagall

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curities underwritten by its United Kingdom merchant bank affiliate. As the court of appeals explained, "this risk exists whenever a bank holding company with an overseas merchant bank affiliate renders investment advice" (Pet. App. 18a n.9). Petitioner's "real challenge," the court concluded (*ibid.*), is thus to the Board's Regulation K, 12 C.F.R. 211.5(d)(13), which permits banks to affiliate with entities that underwrite and distribute securities outside the United States. In any event, both the Board (see Pet. App. 37a n.25) and the court of appeals (see *id.* at 18a n.9) concluded that NatWest's merchant banking activities cannot have adverse effects because NatWest will limit the operations of its overseas securities affiliates to transactions that do not constitute dealing in securities in the United States, and because CSC will make a full disclosure to its customers whenever it proposes to purchase securities that are desired by a customer from an affiliate's inventory. In *ICI II*, the Court found that similar restrictions served to obviate any danger posed by a bank's provision of investment advice. See 450 U.S. at 67 & n.39.

Act (see Pet. App. 44a-48a). Petitioner is incorrect in suggesting that the Board's recent decisions in *Sovran Financial Corp.*, 72 Fed. Res. Bull. 146 (1986), and *United Jersey Banks*, 69 Fed. Res. Bull. 565 (1983), are inconsistent with its approach here. As the court of appeals explained (Pet. App. 18a-20a), neither decision cited by petitioner squarely addressed the issue presented in this case—the proposed combination of brokerage services with investment advice concerning the same class of securities—and both decisions turned at least in part on the dangers posed when a bank affiliate deals in securities "for its own account." *Sovran Financial Corp.*, 72 Fed. Res. Bull. at 148; *United Jersey Banks*, 69 Fed. Res. Bull. at 568.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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